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RUEHKP/AMCONSUL KARACHI 2237
RUEHCG/AMCONSUL CHENNAI 7962
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UNCLAS SECTION 01 OF 03 COLOMBO 001218

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STATE FOR SCA/INS AND EEB/IFD/ODF
MCC FOR S. GROFF, D. TETER, D. NASSIRY AND E. BURKE
TREASURY FOR LESLIE HULL

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SUBJECT: SRI LANKA: GOVERNMENT REVIVES SOVEREIGN BOND ISSUE PLANS; OPPOSITION SEEKS TO BLOCK

REF: A. 06 Colombo 550 B. Colombo 170

¶1. (SBU) Summary: The Government of Sri Lanka plans to issue the country's first international sovereign bond, in hopes of raising $500 million to fund infrastructure projects. However, the main opposition United National Party has announced that a future UNP government would not honor the bonds, which it claims the country cannot afford. UNP reps told us that their effort to sink the bond issue is primarily political though -- an effort to keep the government from being able to buy the continued loyalty of former UNP MPs who joined the government as ministers last January. While markets will likely correctly view the UNP threat as a political move that would never materialize, the timing of the pending bond issue appears to be as bad or worse as sixteen months ago, when the government shelved an earlier plan for a $1 billion sovereign bond issue. Sri Lanka has had little good news to reassure currently skittish international debt markets. Nevertheless, market watchers say that the relatively small bond issue will probably appeal to a sufficient number of international investors who remain interested in diversifying their holdings of high-yielding emerging market debt. End Summary.

$500 MILLION BOND TO FUND
INFRASTRUCTURE, "SET A BENCHMARK"

¶2. (U) The Government of Sri Lanka has revived plans for the country's first international sovereign bond issue. The government seeks to raise $500 million, or more if demand is strong. The government says it intends to invest the cash it raises in infrastructure projects. It also expects the bonds to provide an interest rate benchmark for private Sri Lankan companies seeking to borrow in international capital markets. This is the second time the government has prepared to tap international markets for a large bond issue (ref A). In mid-2006 the government abandoned plans to raise $1 billion when advisor Citibank judged that the resumption of civil war made the timing inopportune.

¶3. (SBU) The Central Bank of Sri Lanka, which will float the bond on behalf of the Government, has selected JP Morgan, Barclays Capital and HSBC as joint lead managers of the issue, from among twelve local and international banks that bid on the role. According to a senior Central Banker, the bank plans an October road show to financial centers like New York, London, Frankfurt, Singapore, and Hong Kong to publicize the planned bond issue.

OPPOSITION SEEKS TO BLOCK THE BOND ISSUE

¶4. (U) The opposition United National Party has challenged the government's plan to issue the bonds. UNP leader Ranil Wickremesinghe wrote to JP Morgan, Barclays, and HSBC August 24, stating that "the bond issue is in violation of the law" and that the "a future Government formed by the United National Party will not be able to honour the repayment obligations under this bond issue." In the letters, Wickremesinghe charges that the government has not informed Parliament of its plans to issue the bonds; that interest payments on the bonds "will hamper the sustainability of Sri Lanka's long-term programme for servicing its existing public debt repayments"; and that the bonds may contribute to corruption, since planned "major infrastructure projects... have all been funded by bilateral and multilateral" lenders. Wickremesinghe sent similar letters to U.S. Securities and Exchange Commission Chairman Christopher Cox and to Cox's UK equivalent, urging them to "consult with the banks concerned and bring to a halt the issuance of this sovereign bond."

¶5. (SBU) A UNP economic advisor told Econoff, however, that if given the opportunity to do so in a future government, the party does not

in fact intend to default on the bonds. The move, he said, is rather a political tactic in the UNP's strategy to bring down the Rajapaksa government. The UNP believes that, if it can block the bond issue, it will be able to lure back former UNP members of parliament who joined the Rajapaksa government as ministers in January (ref B). Conversely, the UNP believes that if the bond goes through, the government will be able to buy the continued support of those MPs by allocating much of the cash to the ministries they control. The advisor stuck with the UNP's charge that the bond issue would violate the law, saying that it would cause the government's total outstanding debt to exceed a maximum established by Parliament. One of the UNP ministers who joined the SLFP in January likewise told Ambassador that the UNP had made, but not followed through on, a similar threat to block the partial privatization of the national airline in the 1990s.

¶6. (SBU) The CEO of HSBC in Sri Lanka discounted the UNP threat as "silly... political tub-thumping." He said there was no way a future UNP government would voluntarily default, and was confident that international markets would be unconcerned by the UNP position. Other international bank and credit rating agency reps gave Econoff the same assessment. (The Colombo-based JP Morgan representative told Econoff he could not comment on the impact of the UNP's letter to JP Morgan while his firm conducted due diligence preparations for the bond issue.)

¶7. (SBU) As for the government's legal right to proceed with the bonds, the senior Central Banker told Econoff that in fact the government had notified Parliament, in its November 2006 budget proposal for 2007, that it planned "foreign borrowings up to one billion dollars." Finance Ministry and Central Bank officials told EconFSN that Foreign Loans are covered under Sri Lanka's Foreign Loans Act and therefore do not need special parliamentary approval and that debt levels under the Fiscal Management Responsibility Act are only targets to improve transparency and accountability, not binding limits.

S&P SAYS SRI LANKA CREDIT OUTLOOK "STABLE"

¶8. (U) On August 9, Standard & Poor's Ratings Services upgraded its outlook on Sri Lanka's credit ratings from "negative" to "stable."

(According to S&P, a negative outlook is used to signal that the rating may be lowered in the near future, whereas stable signals the rating is unlikely to change.) S&P kept Sri Lanka's long-term foreign currency rating unchanged at B+, or four tiers below investment grade. S&P attributed the improved outlook to "higher tax collections, strengthening of fiscal and macroeconomic coordination, elimination of fuel subsidies and revision of electricity prices" and "the limited impact on the economy from the renewed fighting."

¶9. (SBU) The senior Central Banker told Econoff that JP Morgan had been influential in the S&P outlook decision, both by helping the Bank prepare for the S&P assessment and by convincing S&P during its deliberations that the Sri Lankan economy was in fact holding stable. According to the Central Banker, Citibank had not been as helpful in preparing the bank for the April 2007 Fitch Ratings assessment, which ended with Fitch keeping its outlook at "negative." The new local Citibank head acknowledged to Econoff that JP Morgan had beaten Citibank on "customer service," but maintained that Citi would have been a better choice than JP Morgan, Barclay's or HSBC to lead the bond issue.

COMMENT: POLITICS ASIDE, TIMING FAR FROM OPTIMAL
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¶10. (SBU) Aside from its political agenda, the opposition seeks to block this bond issue because it doubts the government will

productively invest the proceeds in infrastructure projects. This is a valid concern on three levels. First, as the opposition fears, the government may well use the funds to retain the loyalty of ex-UNP ministers by permitting them to pursue pork-barrel projects. Second, the government has said it intends to build infrastructure even where there is not currently a market demand (like the Weerawila airport), or which could be built more efficiently by the private sector (like an expanded oil refinery at Sapagaskunda). Third, the government is showing signs of being short on cash to bridge an apparently growing fiscal deficit, so it will likely use some of the bond funds for current, rather than capital, expenditures.

¶11. (SBU) While markets will likely correctly view the UNP threat as a political move that would never materialize, the timing of the pending bond issue appears to be as bad or worse as sixteen months ago, when the government shelved its earlier sovereign bond issue plan. Aside from the S&P outlook returning to stable, Sri Lanka has had little good news to reassure currently skittish international debt markets. Nevertheless, market watchers say that the relatively small bond issue will probably appeal to a sufficient number of international investors who remain interested in diversifying their holdings of high-yielding emerging market debt.
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